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SHIPPING AND AIRCRAFT TAX AGREEMENT WITH THE GOVERNMENT OF THE PEOPLE'S REPUBLIC OF CHINA

REPORT

OF THE

COMMITTEE ON FOREIGN RELATIONS
UNITED STATES SENATE

ON

TREATY DOC. 97-24, 97TH CONGRESS, 2D SESSION, SHIPPING AND AIRCRAFT TAX AGREEMENT WITH THE GOVERNMENT OF THE PEOPLE'S REPUBLIC OF CHINA

JULY 11, 1983.—Ordered to be printed

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Mr. PERCY, from the Committee on Foreign Relations, submitted the following

REPORT

[To accompany Treaty Doc. 97-24, 97th Cong., 2d Sess.]

The Committee on Foreign Relations, to which was referred the Agreement between the Government of the United States of America and the Government of the People's Republic of China with Respect to Mutual Exemption from Taxation of Transportation Income of Shipping and Air Transport Enterprises (Treaty Doc. 97-24), having considered the same, reports favorably thereon, and recommends that the Senate give its advice and consent to ratification thereof.

I. PURPOSE

The principal purpose of the proposed Shipping and Aircraft Tax Agreement between the United States and People's Republic of China is to reduce or eliminate potential double taxation of certain income earned by enterprises and residents of either country from shipping and air transportation. The proposed agreement is intended to eliminate, in the case covered, possible barriers to trade caused by overlapping taxing jurisdictions of the two countries.

II. BACKGROUND

The proposed agreement with the People's Republic of China was signed on March 5, 1982. The proposed agreement would expand on an existing exchange of notes and letters of understanding between the two countries that were signed on November 18, 1981, and that apply retroactively to January 1, 1981. The agreement was transmitted to the Senate for advice and consent to ratification on June 16, 1982.

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III. SUMMARY

The proposed shipping and aircraft income tax agreement between the United States and the People's Republic of China reduces or eliminates double taxation of certain income earned by enterprises and residents of either country from shipping and air transportation. This objective is principally achieved by each country agreeing not to tax income derived in international traffic by enterprises of residents of the other (or, in the case of the People's Republic of China, state-owned enterprises).

In addition, each country agrees not to tax gains from the alienation by an enterprise of the other country of ships, aircraft and containers operated in international traffic. Each country also agrees to exempt from taxation salaries of residents of the other country employed as crew members in international traffic.

The agreement would expand on an existing exchange of notes and letters of understanding between the two countries. The existing exchange of notes and letters of understanding do not provide reciprocal exemption for (1) shipping profits of enterprises of a country that do not register under its laws, (2) air transport profits of enterprises of a country that do not register under its laws in certain circumstances, (3) certain income from rental of ships, aircraft, or containers, (4) gains from alienation of property, or (5) salaries of crew members. The proposed agreement would provide reciprocal exemption in each of these cases.

The agreement would have the effect, under current U.S. tax law, of benefitting a U.S. airline that leases one or more aircraft to the People's Republic of China and which is subject to PRC tax on that rental income, and any similarly situated U.S. taxpayers. It would also benefit those U.S. and PRC shipping enterprises that fly flags of countries not of their residence.

Although the proposed agreement does not specifically provide for the exchange of tax information between the competent authorities of the two countries, it provides for the competent authorities to resolve problems arising under the agreement.

The agreement contains the standard provision (the "saving clause") contained in U.S. tax treaties that each country retains the right to tax its citizens and residents as if the treaty had not come into effect.

The agreement would be effective retroactively to January 1, 1981.

IV. DATE OF ENTRY INTO FORCE AND TERMINATION

Entry into Force

The proposed agreement is subject to completion of legal procedures in each country. Each country is to notify the other in writing through diplomatic channels of completion of those procedures. The agreement is to enter into force on the date of the later of those two notifications and its provisions are to take effect retroactively as of January 1, 1981. Thus, entry into force may entitle certain U.S. or PRC residents to tax refunds upon the filing of appropriate claims.

It is intended that in the United States the agreement will apply to taxable years beginning on or after January 1, 1981, and that in the People's Republic of China, its provisions apply to taxes paid on or after January 1, 1981.

Termination

The proposed agreement will continue in force indefinitely, but either country may terminate it at any time by giving at least six months prior notice through diplomatic channels. Any termination will be effective on the first day of January following the expiration of the six months notice. It is intended that in the United States termination will apply to taxable years beginning on or after that January 1, and that in the People's Republic of China, termination will apply to taxes paid on or after that January 1.

V. COMMITTEE ACTION

The Committee on Foreign Relations held public hearings on the proposed Shipping and Aircraft Tax Agreement between the United States and the People's Republic of China, and on other tax agreements, on May 24, 1983. The Committee considered the proposed agreement on June 28, 1983, and ordered it favorably reported by a voice vote, with the recommendation that the Senate give its advice and consent to its ratification.

VI. COMMITTEE COMMENTS

The Committee on Foreign Relations supports this treaty and agrees with the objective of reaching agreements beneficial to American citizens and corporations. In general, however, the Committee questions the desirability of concluding tax treaties limited to one or two industries and prefers that these issues be dealt with in the context of general income tax treaties with the countries concerned.

VII. BUDGET IMPACT

The Committee estimates that the proposed agreement will have no effect on budget receipts. In accordance with the objectives of section 403 of the Budget Act, the Committee advises that the Director of the Congressional Budget Office has examined the Committee's budget estimate and agrees that there will be no effect on budget receipts. In keeping with the spirit of section 308(a) of the Budget Act, and after consultation with the Director of the Congressional Budget Office, the Committee states that the agreement does not provide any new budget authority or any new or increased tax expenditures.

VIII. EXPLANATION OF THE AGREEMENT'S PROVISIONS

Set forth below is an article-by-article explanation of the proposed Shipping and Aircraft Tax Agreement between the United States and the People's Republic of China.

Article I. (Income from Operation of Ships and Aircraft)

U.S. Rules.—As a general rule, the United States taxes the U.S. source income of a foreign person from the operation of ships or aircraft to or from the United States. An exemption from U.S. tax is provided if the ship or aircraft is documented under the laws of a foreign country that grants an equivalent exemption to U.S. citizens and corporations (secs. 872 & 883). Thus, for its ships and aircraft to benefit from the U.S. tax exemption, a foreign country would have to exempt from tax the income that U.S. persons earn from ships and aircraft documented under the laws of the United States. The foreign country could have its ships and aircraft benefit from this exemption, however, without exempting from its tax the income that U.S. persons earn from ships and aircraft documented under the laws of a third country. The United States has entered into agreements with a number of countries under which that country grants an exemption which results in the United States exempting that country's shipping under the reciprocal exemption provisions of the Internal Revenue Code (secs. 872 & 883).

The statutory exemption for shipping income of ships and aircraft documented under the laws of countries extending a reciprocal exemption includes the income of a lessor from leasing ships under time or voyage charters, and the income of a charterer from the operation of ships under time, voyage, or bare boat charters. The exemption generally does not apply to the income of a lessor from leasing under a bare boat charter. Such income is generally treated as rent received from an investment rather than as shipping income (Rev. Rul. 74-170, 1974-1 C.B. 175). Leasing under a bare boat charter gives rise to exempt shipping income, however, when the lessor is actively engaged in the shipping business and leases a vessel to another as an activity incidental to his shipping business. Whether the lessor of a bare boat chartered vessel is entitled to the exemption is determined on a case by case basis (*id.*).

Certain interest income of a foreign corporation engaged in the shipping business may also be free of U.S. tax. Interest income of such a corporation from funds held for immediate use in the shipping business was held tax exempt on the ground that the interest was incidental to the operation of ships (Rev. Rul. 70-263, 1970-1 C.B. 158).

Proposed Agreement.—The proposed agreement expands upon an exchange of notes and letters of understanding between the two countries of November 18, 1981. Those documents were effective retroactively on January 1, 1981, and are now in effect. The ex-

change of notes governs shipping income (pursuant to sec. 883), and the exchange of letters of understanding governs income from air transportation.

Article I of the proposed agreement provides that income and profits which are derived by an enterprise of one country from the operation of ships and aircraft in international traffic shall be taxable only in that country. Other articles, discussed below, define the terms used in this Article.

The proposed agreement does not contain the domestic registration, or "flag," requirement found in the exchange of notes between the United States and the the People's Republic of China that now governs shipping earnings. Thus, under the proposed agreement, income of a U.S. resident from a ship flying the Liberian flag would generally not be subject to PRC tax. Likewise, income of a PRC enterprise from a ship flying the U.S. flag or the flag of a third country would not be subject to U.S. tax.

One benefit of removal of the "flag" requirement is that, under current U.S. tax law, PRC shipping companies will be able to lease equipment from U.S. owners who obtained the benefits of the investment tax credit, and be exempt from U.S. tax on the income from operating the equipment. These benefits may be passed on by the U.S. owners to the PRC shipping companies in the form of lower rentals. The credit is available for ships which are used predominantly outside the United States only if they are registered or documented under U.S. law. (Code sec. 48(a)(2)(B)(iii)). Because a PRC shipping company could benefit from the exchange of notes only if its vessels were registered under PRC law, it was not possible under the the exchange of notes to combine its benefits with those of the investment tax credit (which requires U.S. registration). This modification in no way restricts the right of the United States to amend its statutory investment credit rules so that the credit would not be available in the case of ships used predominantly outside the United States by persons exempt from U.S. tax under a treaty.

In connection with the exchange of notes now in force, the United States and the People's Republic of China exchanged a letter of understanding about taxation of international aviation operations. That understanding was that as long as earnings from international transportation by PRC air transport enterprises operated in the United States are not taxed in the United States, the People's Republic of China will continue on a reciprocal basis not to tax the earnings of United States international air transport enterprises operated in the People's Republic of China. The reciprocal exemption contemplated by the Internal Revenue Code (and used for shipping income) was not used in the case of aviation income because the PRC airline uses aircraft documented in the United States. However, the PRC airline was not profitable, so no U.S. tax had been due. Therefore, so long as the PRC airline remains unprofitable, this understanding will prevent PRC taxation of earnings from the operations of U.S. aviation enterprises, wherever their aircraft may be registered. The proposed agreement embodies the reciprocal exemption for income from aviation agreed to in that understanding. The proposed agreement's reciprocal exemption will apply regardless of the profitability of the PRC airline. As

is the case with ships, it would permit the PRC airline to lease airplanes from U.S. owners who obtained the benefit of the investment tax credit. (See Code sec. 48(a)(2)(B)(i)). However, as is the case with ships, the agreement in no way restricts the right of the United States to amend its statutory investment tax credit rules to deny the investment tax credit to those U.S. owners.

The agreement applies to local surcharges collected by the PRC national government. However, if any state or locality of the United States imposes tax on PRC enterprises on income and profits from the operation of ships or aircraft in international traffic, then the People's Republic of China may impose any local surcharge on such income and profits of U.S. enterprises.

Article II. (General Definitions)

Article II defines two terms: "income and profits from the operation of ships and aircraft," and "international traffic." These definitions are similar to those of the U.S. model income tax treaty.

The term income and profits from the operation of ships and aircraft includes (but is not limited to) four categories of income and profits derived by an enterprise of the United States or the People's Republic of China. Items in each of these categories are generally exempt from tax in the country of source so long as the taxpayer earns them in international traffic.

The first category of income and profits from the operation of ships and aircraft is income and profits from the operation of passenger, cargo, or mail transportation by the owner or charterer of a ship or aircraft, and the sale of tickets related to such transportation. The intent of this provision is to exempt such income and profits from tax in the source country only if the taxpayer earns them in international traffic.

The second category is income and profits of a lessor from the rental of ships or aircraft that the lessee operates in international traffic. Thus, if a U.S. bank leases a vessel to a third party of any nationality, the U.S. bank's rental income is exempt from PRC tax if the lessee operates the vessel in international traffic.

The third category is income and profits from the rental of ships or aircraft if such rental is incidental to the operation of ships or aircraft in international traffic. If a U.S. shipping enterprise charters a vessel to a third party, the resulting rental income would be exempt from PRC tax since such a charter would be incidental to the U.S. enterprise's shipping operations, regardless of whether the operator uses the vessel in international traffic. That is, the operator (the lessee) in such a case could operate the vessel solely between places in the People's Republic of China without subjecting the lessor to PRC tax. The income of the lessor (the U.S. shipping enterprise) in this example is from the operation of a ship in international traffic, even though the lessee operates in PRC waters, because the lessor's income is incidental to its international operations.

The fourth category is income and profits from the rental or use of containers (and related equipment for the transport of containers) used in international traffic.

Rental income and profits in the second, third, and fourth categories are governed by the proposed agreement whether the rental is on a time, voyage, or bare boat basis.

International traffic means, with respect to an enterprise of a country, any transportation by ship or aircraft, except where the transportation is solely between places in the other country. The meaning of the term "international traffic" is the same as that in the U.S. model income tax treaty and is substantially similar to that in the OECD model. Thus, coastal shipping along the Atlantic coast of the United States is not international traffic with respect to a PRC enterprise. Transport between the United States and American Samoa, however, is international traffic with respect to a PRC enterprise. If a resident of the People's Republic of China transports goods by ship from Canada to the United States, leaving some of the goods in New York and the remainder in Norfolk, the portion of the transport between New York and Norfolk is international traffic; if it also loads other merchandise in New York which it takes to Norfolk, the income from the transport of the goods loaded in New York is not from international traffic.

Article III. (Alienation of Ships, Aircraft, and Containers)

Under the Code, capital gains derived from U.S. sources by foreign investors are generally exempt from U.S. tax. The proposed agreement provides that gains derived by an enterprise of one country from the sale or exchange of ships, aircraft or containers operated in international traffic are taxable only by the country of residence. This rule appears in the U.S. model income tax treaty.

Article IV. (Definition of Enterprise)

The proposed agreement applies only to the income of an enterprise of the United States or the People's Republic of China. For purposes of the proposed agreement, the term "enterprise" means: in the case of the People's Republic of China, a state-owned or collectively-owned enterprise of, and an enterprise carried on by a resident of, the People's Republic of China; and in the case of the United States, an enterprise carried on by a company incorporated in the United States (under the laws of the United States, a state thereof, or the District of Columbia), and an enterprise carried on by a U.S. resident. Citizens of one of the countries who are not residents of one of the countries are not covered by the agreement. U.S. citizens and PRC citizens who are not resident in either country remain subject to the exchange of notes and letters of understanding, however, which remain in force for such persons.

The term "enterprise" also includes a participation in a partnership or joint business by an enterprise referred to in the general definition of enterprise above. This definition generally conforms to that of the U.S. Model.

Article V. (Salaries and Other Remuneration)

The proposed agreement provides that compensation derived by a resident of one country employed as a member of the crew of a ship or aircraft operated in international traffic shall be exempt from tax in the other country. This rule is substantially identical to the rule of the U.S. model treaty.

Article VI. (Mutual Agreement Procedure)

The proposed agreement contains an abbreviated version of the mutual agreement provision contained in U.S. tax treaties generally. The proposed agreement's provision directs the competent authorities to resolve any difficulties or doubts arising as to the application of the convention. Although the proposed agreement does not define the term competent authority, that term means, in the case of the United States, the Secretary of Treasury or his delegate. In fact, the U.S. competent authority function has been delegated to the Commissioner of the Internal Revenue Service, who has redelegated the authority to the Associate Commissioner (Operations). The Assistant Commissioner (Examination) has been delegated the authority to administer programs for simultaneous, spontaneous, and industry-wide exchanges of information. The Director, Foreign Operations District (formerly called the Director of the Office of International Operations), has been delegated the authority to administer programs for routine and specific exchanges of information and mutual assistance in collection.

The proposed agreement does not contain a provision for the exchange of information between the competent authorities of the two countries. The mutual agreement provision of Article VI would allow the U.S. competent authority access to information adequate to enforce U.S. taxes affected by the agreement.

Article VII. (Saving Clause)

The proposed agreement contains the "saving clause" contained in all U.S. income tax treaties that provides that the agreement is not to affect the taxation by either country of its citizens or its residents. Consequently the United States could continue to tax its citizens who are residents of the People's Republic of China and who are members of the crew of a ship or aircraft operated in international traffic despite the rule of Article V. Residents for purposes of the agreement (and thus, for purposes of the saving clause) include corporations and other entities as well as individuals.

Article VIII. (Entry into Force)

The proposed agreement is subject to completion of legal procedures in each country. Each country is to notify the other in writing through diplomatic channels of completion of those procedures. The agreement is to enter into force on the date of the later of those two notifications and its provisions are to take effect retroactively on January 1, 1981. Thus, entry into force may entitle certain U.S. or PRC residents to tax refunds upon the filing of appropriate claims.

It is intended that in the United States the agreement will apply to taxable years beginning on or after January 1, 1981, and that in the People's Republic of China, its provisions apply to taxes paid on or after January 1, 1981.

Article IX. (Termination)

The proposed agreement will continue in force indefinitely, but either country may terminate it at any time by giving at least six months prior notice to the other through diplomatic channels. Any

termination will be effective on the first day of January following the expiration of the six months notice.

It is intended that in the United States termination will apply to taxable years beginning on or after that January 1, and that in the People's Republic of China, termination will apply to taxes paid on or after that January 1.

IX. TEXT OF THE RESOLUTION OF RATIFICATION

Resolved (two-thirds of the Senators present concurring therein), That the Senate advise and consent to the ratification of the Agreement between the Government of the United States of America and the Government of the People's Republic of China with Respect to Mutual Exemption from Taxation of Transportation Income of Shipping and Air Transport Enterprises, signed at Beijing on March 5, 1982.

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